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TRENDS

An Analysis of Emerging Trends in the Securities Industry

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"THE INSTITUTIONAL BUSINESS IN THE 1990's"

REMARKS OF
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I have been asked to discuss the institutional business in the 1990's. There are many different subjects that one can characterize as institutional business, and I do not want to oversimplify the subject. Many individuals involved with regional firms have unique opportunities in dealing with institutions with their own set of challenges and opportunities.

I want to cover the part of the business that is done with larger institutions. I will discuss the business as though it were one business, that is without making constant distinctions between fixed income securities and equities. That would not have been possible two or three years ago because there were some very important divergences in those two major segments, but it seems that those two businesses are more and more experiencing similar difficulties for many of the same reasons.

Based on a presentation by Richard B. Fisher, President, Morgan Stanley Group Inc. at SIA's 1989 Annual Convention. These remarks were edited by Jeffrey Schaefer for written form purposes only. SIA welcomes contributions to Trends from member firms and others on subjects relating to the securities industry and capital markets. Please send submissions to the attention of Jeffrey Schaefer, SIA Research Department.

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All institutional businesses are now under maximum pressure. There are several reasons for this. First is a very simple one that we all learned in our basic economics textbooks in college, at least for those who bought the book, namely that any long period of reasonable prosperity in a business segment will attract excess investment; and that, of course, is what happened. We have substantial overcapacity in the institutional businesses in both fixed income and equities today because of normal business cycle reasons.

Beyond that, though, securities firms seem willing to accept poor returns in institutional businesses longer than they should by any standard of rational economic analysis. I cannot explain this phenomenon but I want to suggest a few reasons.

Some firms do not know their costs. They are in a business that is revenue oriented and has been for years. The amount of times a decision is based on both revenue and cost information in our business is less than it should be.

Some firms may have valid commercial reasons for, in effect, over investing in the institutional business. For instance, a certain type of firm may need to have distribution in place in order to be competitive for capital markets financing. You can not in today's world be the lead manager in a significant financing, if you can not deliver on the distribution side.

The next factor, which really ties into the second explanation, is that many securities firms continue to be market share and volume oriented and not enough oriented toward what the long-term earnings prospects are for any given level of investment in the business. Probably the most classic example occurred a few years ago in London. We were all given an opportunity when the Bank of England announced that they were going to increase the number of authorized dealers in the gilt business, the most important part of the government securities business in the U.K. At that time, there were eight authorized gilt dealers, and the number was to be increased to somewhere between 30 and 35, depending upon how many firms applied. We discussed this possibility for a long time at Morgan Stanley, and it seems to us from material contained in a very detailed 30 page memoranda that going from 6-30 dealers in a business not increasing in volume led to fairly obvious conclusions. It was not a business to enter.

The Bank of England had many more applications than they needed to expand to over 30 dealers, and a group of firms was given permission. Sure enough, over the next period of several years, less than 5 firms could claim a reasonable return in the gilt market. That type of event seems to happen regularly in our business which is volume, revenue and market share oriented.

My conclusion from this discussion is that we have substantial overcapacity of both people and capital in the institutional business. It is difficult to suggest the percentage of overcapacity. However, I want to try in order to give you some idea of what we have in mind. It is surely not marginal. My guess is it is something like 20 to 25 percent too much capacity in those businesses.

The second major point, which is just as important, is that the problem is not going to be fixed by cyclical increases in volume. I do not see any realistic estimate of volumes and of revenue/cost relationship in the next three years to justify today's level of investment. We have got overcapacity regardless of what

happens to volumes of transactions going forward. The business cycle will not bail our industry out.

There are a number of other factors which we will cover quickly because you have other sources of information which most industry representatives are familiar with. The first is the increasing commoditization of large sectors of the business. Obviously, technology has had a major influence on this trend. I was standing behind one of our government traders the other day and he had eleven screens at his trading position with different kinds of information. I said, "Gee, that is terrific!" He said, "No, it is not. I have got eleven. The customers have twelve." That pretty much summarizes the impact of technology in the commoditization of certain kinds of business. Market information is not a way to add value today. There is no scarcity of sources of market information.

The next fact that has been a very negative factor for certain firms is the whole soft dollar 28E situation. It is a loaded subject, and many people have different views on it, but let me give you one fact. Since October of '87, the NYSE volume is down 10 percent, on average. In comparison, the full-service firms' listed commissions are down 40 percent in that period. In other words, the major full service firms are bearing the brunt of the soft dollar increase to boutiques, which is very simple to understand. Soft dollars become fixed payments. They are the first obligations that asset managers need to discharge, and the full-service trading and research firms are moved further and further down the line, both in terms of levels of revenue and order flow quality.

The large trading firms have had a major decline in the quality of the order flow they see. We simply do not see 2,000 shares of Telephone to buy or sell. That goes to the third party soft dollar vendors because presumably it is an execution that can be dealt with easily. In any event, this is a major problem for us and other firms similar to ours. It is one that has received the attention of regulators recently and probably will continue to, and it has a major negative impact on the institutional business.

The other factor is that more assets are being shifted into passive money management strategies. Institutions are trading portfolios rather than stocks, and they simply will not pay for services that focus on stock selection. As more and more assets become managed through passive strategies, the marginal value of stock selection information lessens.

Furthermore, there are a whole host of reasons that put further pressure on both commission and trading levels, and all of that combined summarizes the reasons behind why institutional businesses are in the poor shape they are in today.

Let us look forward a bit. My basic theme is that we are going to see a major change in the institutional business as time goes on. The simplest way to express this trend is that we will see the final move away from earned agency commissions or dealer order flow in return for providing market information. This is not a viable business today, and it is going to be increasingly more obvious that it does not have any chance of existing as a profitable business in the future.

What will replace this particular business is that money will be managed very differently in the '90's, and we, as intermediaries, have to find ways to add value. There is no question that there will be opportunities. It is not that money managers

in the '90's are not going to need any help by any means. It is simply that they will need a different kind of help; and if we do not adjust to that quite substantially, we will see a continued decline in the profitability of institutional businesses.

Let us look at the few things I think will cause this complete shift. The first is globalization. We have been reading about globalization for 12 years now. This may lead some people to conclude that globalization is over. But, if you look at the facts, it has hardly begun. In our view, it will continue, at the very least, to be the dominant trend in world financial markets and will generate very large trading volumes.

There is more and more international money available for flows every day. In other words, as Japanese equity prices, for instance, are more and more priced by international flows and less and less by domestic Japanese flows, we are going to see a very large statistical arbitrage around the world. That is going to create enormous volumes for all of us to have access to as intermediaries. But this order flow will be done with firms for very different reasons than in the past.

The second factor is that interest will continue to move away from conventional cash markets for financial assets. By that, I mean complicated strategies will be used by global investors including the use of options and futures. It will have to do with currency related investments, whether it is bonds that have interest payments in one currency and maturity payments in another, tremendous shifts toward innovation and new kinds of instruments. It will also include the use of commodities and precious metals with financial instruments related to them. The list is very extensive as to why I think interest on the part of global money managers will continue to shift away from simple, conventional cash markets to other markets.

A further point has to do with changes taking place with institutional customers. There has a lot going on with them, and obviously it is important to understand what is happening to asset managers in terms of their own business requirements. In my opinion, the margin pressure of the '80's on the securities industry is going to shift, or at least spread, to the asset management business in the '90's, for several reasons.

The first is that assets will continue to migrate to lower margin sectors from the asset manager's point of view. In other words, the fees involved in passive management are substantially below the fees involved in active management; and as more and more assets shift in those directions whether its 100 percent passive or quasi-passive or asset allocation strategies, such shifts have negative implications for the operating margins of asset managers.

Secondly, I think assets will continue to move in house, back to the owners for the simple reason that passive strategies are much easier for large private pension plans, for instance, to manage in house.

Finally, the declining profitability of our institutional businesses is going to have implications for our institutional customers. Sooner or later, we will stop providing services - whether it is research or liquidity or first-rate sales services, etc. because we simply will not be compensated for them. That is going to move costs internally to the asset mangers. They are going to have to replace those services in one way or another.

As a result of all these trends, our market will continue to be institutionalized. I think the number of participants will decrease on both the buy and the sell side as the capacity corrections assert themselves; and, as I say, as more and more managers want to buy and sell portfolios and not stocks. If the picture that I have outlined turns out to be reasonably accurate, we will have to learn to live with an increase in price volatility.

There are two ways to regard volatility. The first is that increased volatility is simply unacceptable and terrible and we have got to do something about volatility in a legislative sense. Or you can look at it as an inevitable characteristic of markets under certain conditions and volatility is like any other problem. It has both severe problems and substantial opportunities for organizations that will try and learn to deal with volatility. Instead of volatility taking advantage of you and your firm, look for ways to incorporate assumptions about volatility into your business. Firms must find ways where they are able to reduce or eliminate the impact of or take advantage of volatility.

To summarize, I think that the rate of change in the institutional business will increase in the '90's. I think capacity reduction is necessary for us in the institutional business. It is going to develop in the future by firms getting out of businesses rather than simply cutting back. Again, it will not only be further reductions of head count in existing businesses. That is behind us. A lot of firms have reduced their number of employees in certain businesses, but I do not think we can get the percent reduction that is necessary by more of that.

We are going to see firms exiting businesses completely, frankly, much like what happened in London about a year ago. Morgan Grenfell got out of the equity business completely. That was a major decision for a major U.K. merchant bank to say that "we are not going to try to deal with this problem by reducing further our head count." They got out of the business, and as they say in London "made 480 people redundant." In this country, if you are redundant, it means you are fired.

One of my conclusions is that no one will continue to be able to earn reasonable returns by simply providing market information and executing agency trades. It is going to be much more complicated than that, and I think the following changes is what it is going to take. Institutional business managers will have to be very flexible in thinking about what their client wants because that is constantly changing. The clients are going to want something different in th '90's than they needed in the past; and, of course, the toughest part is to try to figure out what they will pay for. That creates two levels of difficulties. First, you have to know exactly what it is they will judge as having added value; and secondly, you have to make some judgments about how your organization will get compensated at levels that will enable you to earn a fair return.

Moreover, you have got to know your costs. A major change has to occur in this area and I do not think our industry has done enough work on this subject. At the larger institutional end, you have to think globally. Globalization has just begun, and we are not even close to understanding what the implications of globalization are for financial institutions around the world. It is going to be a very powerful trend in the future as, in fact, portfolios become globalized.

There are two problems with the global trend. One is the high cost of doing business globally. There is no question about these costs; but what you have got to focus on is not lamenting the high costs but figuring out how to get your cost

structure competitive. Like any other business challenge, there is a way to deal with it.

The second problem, of course, is that many of the firms you compete with on a global basis are very large. We have heard a great deal about the size of Japanese firms but I think U.S. firms, in spite of their relative lack of size compared to large Japanese firms, are very competitive.

Finally, you have to be committed to using technology. This is something we hear about all the time. Very few of us really know what it means, but we have got to think it through. We have got to use technology intelligently, both to make better decisions and to get costs down.

Let me now finish on an up note because it is something that I really believe in. The securities business was in great difficulty many times in the past. There has been at least five bad cycles. In fact, when I told the placement officer at the Harvard Business School that I was going to join Morgan Stanley, he said, "do not do that. They are not going to be needed in the future." He also said to join Morgan Stanley required three things in 1962. He looked at me and he said, "You have to have blood, money and brains, and at best you have got one of those."

In any event, I really think that our industry is going to deal with the set of problems that we have been through as history shows at least five times already in my career. This industry has one of the greatest collections of entrepreneurs in any business in the world. We will figure our problems out as we have done many times before. In spite of the fact that there are some severe problems facing us now in terms of structure, there is also no question in my mind that the volume of business and transactions in the financial markets are going to be very favorable in the '90's. The firms that figure the problems and opportunities out are going to have some very interesting rate of return opportunities during the next decade.

PRICES
(END OF MONTH)

	DEC. 1989	DEC. 1988	% CHG DEC. 1989-1988
DOW JONES INDUSTRIALS	2753.20	2168.57	26.96%
STANDARD & POOR'S 500	353.40	277.72	27.25%
NYSE COMPOSITE	195.04	156.26	24.82%
AMEX MARKET VALUE INDEX	378.00	306.01	23.53%
VALUE LINE COMPOSITE	258.78	232.68	11.22%
NASDAQ COMPOSITE	454.82	381.38	19.26%

YIELDS
(MONTHLY AVERAGES)

	DEC. 1989	DEC. 1988	BASIS POINT CHG 1989-1988
BOND BUYER INDEX (20 BOND)	6.98%	7.61%	(63)
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	8.86	9.57	(71)
Baa CORPORATE	9.82	10.65	(83)
RATIO Aaa CORPS. TO Baa CORPS.	0.90	0.90	0

VOLUME

	DEC. 1989	YTD 1989	DEC. 1988	YTD 1988	% CHG YTD 1989-1988
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	160.7	165.2	135.5	161.5	2.3%
AMEX (MILS.)*	13.2	12.4	11.1	9.9	24.8%
NASDAQ (MILS.)*	138.0	133.0	118.5	122.8	8.3%
REGIONAL EXCHANGE (MILS.)*	27.2	26.4	24.5	23.3	13.2%
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	$110,991	$1,542,847	$91,202	$1,356,051	13.8%
AMEX (MILS.)	3,365	44,401	2,184	30,922	43.6%
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	9,630	121,090	7,281	86,210	40.3%
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	14,534	202,571	16,497	181,894	11.4%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	51.0%	51.1%	51.1%	54.2%	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	7,799	126,765	8,305	111,784	13.4%
AMEX OPTIONS	3,380	42,576	2,629	37,470	13.6%
COMMODITY	16,567	267,385	18,494	245,871	8.8%

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

UNDERWRITING

	FULL YEAR 1989	FULL YEAR 1988	% CHANGE 1989-1988
CORPORATE FINANCING (Gross New Issues - $ Mils)			
TOTAL	$309,351.9	$274,943.2	12.5%
Common Stock	$23,173.4	$29,820.5	-22.3%
# of Common Stock Issues	470	420	11.9%
Preferred Stock	$7,591.6	$7,400.5	2.6%
# of Preferred Stock Issues	105	123	-14.6%
Corporate Debt	$278,526.9	$237,722.2	17.2%
# of Corporate Debt Issues	4158	3115	33.5%
MUNICIPAL FINANCING (Gross New Issues - $ Mils)			
Negotiated	$88,157.0	$87,720.7	0.5%
# of Issues	4252	4149	2.5%
Competitive	$29,812.1	$26,873.3	10.9%
# of Issues	3599	3695	-2.6%

Source: IDD Information Services Inc.

Item	Description	Source
U.S. Trade Protection: Effects on the Industrial and Regional Composition of Employment	Proponents of trade protection argue that trade restraints bolster overall employment. Although trade protection generally increases employment in the protected industry, it tends to reduce employment in other industries. This study measures the effects of trade restraints on the distribution of employment across industries and regions of the United States. The study examines the impact of trade protection on the textiles and apparel, steel and automobile industries.	Federal Reserve Bank of Dollars Public Affairs Department Station K Dallas, TX 214/651-6289 January(990-9552)
"Global Finance and the Retreat To Managed Trade"	The competitiveness debate that today focuses on industrial performance will soon confront something even more fundamental: money. The rise of foreign financial powers, particularly the Japanese, and U.S. economic problems threatens one of the few sectors in which the U.S. is more creative, sophisticated and aggressive than its rivals. This article explores the competitiveness of the U.S. financial services industry and the movement toward managed trade.	Harvard Business Review Harvard Business School Tele Hall Soldier's Field Road Boston, MA 02163
"Shareholder Rights Abroad: A Handbook For The Global Investor"	This handbook probes the extent of shareholder's rights in nine of the largest non-U.S. equity markets. It is designed to provide institutional investors with an analysis of the issues arising around foreign shareholding, together with a country-by-country index of opportunities and restraints affecting investor activism.	Investor Responsibility Research Center 1755 Massachusetts Avenue, N.W. Washington, DC 20036
International Tax Comparisons	Prepared in conjunction with Spicer & Oppenheim, this study provides and overview of the taxation of gains, dividends and interest on portfolio stock investments of individuals in the U.S. and ten other industrialized countries and six Pacific Basin countries.	Securities Industry Association

Japan and Germany: American Concerns	Today, in one of history's great role reversals, Tokyo and Bonn have become Washingtons fierce trading rivals and also its primary bankers. In the 1990s economic pressures are likely to be the major factor reshaping ties among the three nations. Tokyo and Bonn could present the U.S. with almost intractable problems deriving from their domestic drives, which in some cases their interests could converse in opposition to America's needs. This article examines how the U.S. should deal with the new economic reality.	Foreign Affairs Council on Foreign Relations, Inc. 58 East 68th Street New York, NY 10021
International Challenge for American Banking	This study focuses on three public policy issues that concern the U.S. and all countries with whom it maintains active economic and financial relationships. To this end, the study examines three questions. First, should limits be imposed on foreign ownership of U.S. financial institutions? Two, How "level" is the international financial playing field? Three, what is the role of government in "guiding" private bankers doing business abroad?	Center for the Study of American Business Washington University Campus Box 1208 One Brookings Drive St. Louis, MO 63130 Formal Publication, Number 94
Securities Operator: A Guide to Operations And Information Systems In The Securities Industry	The explosion in both domestic and international trading of securities has centered attention on the need to develop modern systems for more efficient and effective operations worldwide. This book ties together the much-needed information on the "back office" and the "data processing" functions of the U.S. and international securities industries. The book provides specific information on both domestic and international trading support, with a contemporary and comprehensive analysis of securities processing and technology.	New York Institute of of Finance Publishing & Professional Information Services 70 Pine Street New York, NY 10270-0003 212/344-2900

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